No. 11155

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

GEORGE W. YOST, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

UPON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

PETITIONER'S BRIEF

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OPINION BELOW

The only previous opinion in this case is the opinion of the Tax Court of the United States, 5 T.C. ....., No. 16 (R. 27-45).

JURISDICTION

This is a proceeding to review a decision of the Tax Court of the United States, entered May 28, 1945, determining petitioner's liability for additional income taxes for the calendar years 1940 and 1941 in the respective amounts of $75.44 and $1,071.70 (R. 45-46).

From respondent's determination of proposed deficiencies for each of said years, an appeal was taken to the Tax Court of the United States under Section 272(a) I.R.C. (R. 3-21).

By stipulation (R.46) said cause was consolidated for hearing and opinion with an identical cause of petitioner's wife, Juanita Yost, and the Tax Court's opinion in the consolidated cause was filed May 28, 1945 (R. 27-45), and is reported as 5 T.C. ....., No. 16. The Tax Court's decision thereon against this petitioner was entered on May 28, 1945 (R. 45-46).

Petitioner and his wife, Juanita Yost, reside at Edmonds, Washington, and they filed separate income tax returns on the community property basis for each of the years 1940 and 1941 with the Collector of Internal Revenue at Tacoma, Washington, within this circuit (Stip. 1, R.46).

This appeal was taken by Petition for Review filed August 24, 1945 (R. 161-172) and notice of such filing was served on respondent the same day and filed August 25, 1945 (R. 172-173).

(A separate appeal was taken by petitioner's wife, Juanita Yost, at the same time, but by Order of this Court entered on September 12, 1945 (R. 174-176), only the record and the briefs in this case were to be printed.)

This Court has jurisdiction under Sections 1141 and 1142 I.R.C.

STATEMENT OF THE CASE

The question involved in this review is:

Did the amounts of $2,603.65 and $12,799.99 received by the marital community composed of George W. Yost and Juanita Yost in the years 1940 and 1941, respectively, from Richard B. Newell and Robert L. Newell (over and above the repayment by said Newells of their loans), constitute ordinary income of said marital community, of which petitioner's one-half share thereof was fully taxable to him in the respective years (as contended by respondent and held by the Tax Court), or were said amounts derived from the sale or exchange of capital assets and thus constituted long-term capital gains to said marital community under Section 117 I.R.C., and as such only 50% of petitioner's one-half share thereof should be taken into account for income tax purposes of petitioner in the respective years (as contended by petitioner)?

The case was tried to the Tax Court on a stipulation of facts (R. 46-60) to which were annexed eleven exhibits (R. 60-118), and the oral testimony of petitioner (R. 129-139), Robert L. Newell (R. 140-144) and Paul R. Strout (R. 145-149).

The Tax Court found the stipulated facts (R. 28-40) and made additional findings from the oral testimony (R. 40).

The following is a summary of the facts found by the Tax Court, together with references to the printed record:

Tricoach Corporation, a Washington corporation

with its principal office at Seattle, was organized in January, 1935, by George W. Yost, who had been engaged in the bus transportation business in suburban Seattle, by Richard B. Newell, who had been draftsmman and chief engineer for Heiser's, Inc., a Seattle manufacturer of bus and truck bodies, and by Robert L. Newell, who had been selling bus and truck bodies throughout the Pacific Northwest for a Portland, Oregon, concern (Stip. 4, 5, R. 47, 48; Opinion R. 28, 29).

Its authorized capital was $50,000, composed of 1,000 shares of the par value of $50.00 each. Yost subscribed for 150 shares, paying $7,500.00 therefor, and each of the Newells subscribed for 5 shares, each paying $250.00 (Stip. 6; R. 48; Opinion R. 29).

During its entire operation, Robert was president and sales manager; Richard was vice-president, treasurer and chief engineer; and Yost was secretary (Stip. 7, R. 48; Opinion R. 29).

The salary of each of the Newells was originally fixed at $250.00 per month, but in addition thereto they and Yost were each to receive adjusted compensation at the end of each year equivalent to one-third of the year's net profits after provision for payment of dividends on the outstanding stock (Stip. 7, R. 48; Opinion R. 29, 30).

The eleven months of 1935 resulted in a deficit of $1,068.18, which was wiped out in 1936 by Yost contributing $1,001.42 and each of the Newells $33.38, being pro rata according to their stockholdings (Stip. 8, 10, R. 49, 51).

The year 1936 was profitable, Yost receiving in that year $10,140.95 as adjusted compensation and $11,649.64 in dividends, while each of the Newells received salary and adjusted compensation totaling $13,440.95 (their salaries having been increased to $300.00 per month commencing in July) and $388.32 in dividends (Stip. 9, 10; R. 49, 50; Opinion R. 30).

In December, 1936, 764 additional shares were issued at par, 348 to Yost, and 208 to each of the Newells, making 924 shares outstanding and a paid-in capital of $46,200.00 (Stip. 9, R. 50; Opinion R. 30).

The year 1937 was also profitable, Yost receiving in that year $11,927.71 in adjusted compensation and $7,968.08 in dividends, and each of the Newells received salary and adjusted compensation totaling $15,527.71 and also $3,827.81 in dividends (Stip. 12, 13, R. 51, 52; Opinion R. 30).

In December, 1937, the remaining 76 shares were issued at par, 12 shares to Yost and 32 shares to each of the Newells, making the stockholdings then, Yost 510 shares and each of the Newells 245 (Stip. 11, R. 50; Opinion R. 30).

By the end of 1937, Yost, on his original investment in Tricoach of $7,500.00, had received in dividends and adjusted compensation a total of $41,686.38, out of which he had paid to Tricoach $1,001.42 as his pro rata of the 1935 deficit and $18,000.00 for 360 additional shares of stock, leaving him with a net amount of $22,684.96 and he owned 510 fully paid up shares, or 51% of the stock of Tricoach (Stip. 14, R. 53; Opinion R. 31).

In March, 1936, Heiser's, Inc. made an assignment for the benefit of creditors, and all its machinery and equipment were sold to Pacific Car & Foundry Co. (hereinafter referred to as Pacific). Pacific installed said machinery in its Renton plant and commenced manufacturing bus bodies in competition with Tricoach, which resulted in considerable losses to Pacific in each of the years 1936 and 1937 (Stip. 16, R. 54; Opinion R. 32).

For several months throughout 1938, Pacific negotiated with the Newells and Yost for the purpose of accomplishing a merger or working out some method of eliminating the competition of Tricoach, and to secure the services of the two Newells to manage the production and sales of the motor coach division of Pacific. The arrangement finally worked out contemplated leasing by Tricoach of its machinery and equipment to the Newells for ten years, together with an option to them to purchase it by December 31, 1938, at its depreciated book value. The Newells were to sublease to Pacific all of the Tricoach machinery and equipment for 7½ years, from October 1, 1938, and it was to be moved, at Pacific's expense, to its Renton plant. Pacific was to operate its motor coach division for 7½ years from October 1, 1938, to employ the Newells for said period at a minimum salary of $250.00 per month each, and in addition thereto, to pay each of the Newells one-sixth of the profits of the motor coach division earned during said term. Richard was to have charge of the production end and Robert was to manage the balance of the business. Pacific was to purchase, as needed, for cash at

then market prices, all of Tricoach's materials inventory, and to furnish free storage space for said inventory, if moved to the Renton plant. Such arrangement (Exh. 7, R. 80-104) is referred to in the opinion as the four-party agreement (Stip. 17, R. 54; Opinion R. 32, 33).

Since such arrangement would mean liquidation of Tricoach at the par value of its stock, as its earnings had previously been all distributed as adjusted compensation and dividends, Yost would not consent to such arrangement unless he were paid something over and above the liquidation value of his stock (R. 133, Opinion R. 40). In order to get Yost's consent, each of the Newells agreed to pay Yost a maximum of $12,500.00, *i.e.*, one-third of the first $37,500.00 each Newell was to receive out of his one-sixth of the net profits of the motor coach division of Pacific. Separate agreemments were entered into by Yost with each Newell, whereby Yost agreed to loan each $4,187.83, without interest. to be used by them to acquire from Tricoach for cash its machinery and equipment under the option. Each Newell agreed to pay to Yost one-third of the first $37,500.00 each of them received out of his one-sixth of the net profits of Pacific's motor coach division, one-half of such payments to be applied in payment of their respective loans of $4,187.83 until full payment thereof (Exh. 8 and 9, R. 104-111, Opinion R. 33-35).

To accomplish these arrangements, on August 2, 1938, a joint stockholders' and directors' meeting of Tricoach was held, at which it was resolved to discontinue its manufacturing operations about October 1,

1938; to gradually liquidate its affairs; to enter into the agreement with Pacific; and to enter into a lease and option agreement with the Newells in regard to Tricoach's machinery and equipment (Stip. 20, R. 56; Opinion R. 35-37).

On August 3, 1938, the separate agreements between Yost and the two Newells were executed and the four-party agreement also executed (Stip. 21, 22, R. 57; Opinion R. 35).

In 1940 the Newells paid to Yost, under their respective agreements, the following amounts, which were applied by Yost as follows:

	From Robert L. Newell	*From Richard B. Newell*	*Total*
Payments received	$2,603.65	$2,603.65	$5,207.30
Applied toward payment of their loans	1,301.83	1,301.82	2,603.65
Treated as a community capital gain	$1,301.82	$1,301.83	$2,603.65

(Stip. 23, R. 57; Opinion R. 37)

On June 26, 1940, Yost received $25,500.00 and the two Newells each $12,250.00 from Tricoach as liquidating dividends. As Yost's stock had cost him $25,500.00 plus $1,001.42 as his share of the 1935 deficit, it had a basis in his hands of $26,501.42. Respondent, in determining the deficiences for 1940, allowed as a community deduction 50% of said long-term capital loss of $1,001.42, or $500.71, and allowed each of the Yosts a deductible loss of one-half thereof, or $250.35, which item is not in controversy (Stip. 24, R. 51-58; Opinion R. 38).

In 1941 the Newells paid to Yost, under their re-

spective agreements, the following amounts, which were applied by Yost as follows:

	From Robert L. Newell	*From Richard B. Newell*	*Total*
Payments received	$9,286.00	$9,286.00	$18,572.00
Applied toward balance of loans	2,886.00	2,886.01	5,772.01
Treated as a community capital gain	$6,400.00	$6,399.99	$12,799.99

(Stip. 25, R. 58; Opinion R. 38-39)

In 1942 the Newells each paid Yost $610.34, making the total received by Yost from the two Newells, $24,999.98 (Stip. 26, R. 58-59; Opinion R. 39).

In petitioner's 1940 income tax return, he reported as a long-term capital gain $1,301.82, being his community one-half of the $2,603.65 received from the two Newells in 1940 after the above mentioned application on their indebtedness, and as such long-term capital gain, there was taken into account for tax purposes, only 50% thereof, or $650.91 (Stip. 27, R. 59; Opinion R. 39).

Respondent, in his deficiency letter, held that said amount of $1,301.82 received bby petitioner in 1940 was not a capital gain but was ordinary income taxable in full, thereby increasing petitioner's taxable income for 1940 by $650.91 (R. 39) nd the Tax Court sustained respondent's action in so doing (R. 45).

In petitioner's 1941 income tax return, he reported as a long-term capital gain $6,400.00, being his community one-half of the $12,799.99 received from the two Newells in 1941 after the above mentioned application on the balance of their indebtedness, and as

such long-term capital gain, there was taken into account, for tax purposes, only 50% thereof, or $3,200.00 (Stip. 30, R. 59-60; Opinion R. 39-40).

Respondent, in his deficiency letter, held that said amount of $6,400.00 received by petitioner in 1941 was not a capital gain but was ordinary income taxable in full, thereby increasing petitioner's taxable income for 1941 by $3,200.00 (R. 40) and the Tax Court sustained respondent's action in so doing (R. 45).

Petitioner contends that such payments received in each of the years 1940 and 1941 (over and above repayments on the loans) were derived from the sale or exchange of capital assets, and thus constituted long-term capital gains, and that only 50% of petitioner's community one-half interest thereof was taxable to him.

ASSIGNMENTS OF ERROR

In setting forth the Assignments of Error herein, there has been combined Assignments of Error 1 and 2, also 3 and 4, as set forth in the Petition for Review. Assignment of Error I covers the sole question involved in this proceeding and II is applicable if petitioner's contention is upheld.

I

The Tax Court erred in holding and deciding that the amounts of $2,603.65 and $12,799.99 received by the marital community composed of George W. Yost and Juanita Yost in 1940 and 1941, respectively, from Richard B. Newell and Robert L. Newell (over and above the repayment by said Newells of their loans), constituted ordinary income and that petitioner's community one-half interest thereof was fully taxable to him, and in failing to hold and decide that said amounts were derived from the sale or exchange of capital assets and thus constituted long-term capital gains, and that only 50% of petitioner's community one-half interest thereof was taxable to him.

II

The Tax Court erred in ordering and deciding that there are deficiencies in petitioner's income taxes of $75.44 for 1940 and $1,071.70 for 1941, and in failing to order and decide that there is a deficiency in petitioner's income tax for 1940 of $2.57 and no deficiency for 1941.

ARGUMENT

I.

The Amounts of $2,603.65 and $12,799.99 Received by the Marital Community Composed of George W. Yost and Juanita Yost in 1940 and 1941, Respectively, from Richard B. Newell and Robert L. Newell (Over and Above the Repayment by said Newells of Their Loans) Were Amounts Derived from the Sale or Exchange of Capital Assets and thus Constituted Long-Term Capital Gains to the Marital Community Under Section 117 I.R.C., and as such, Only 50% of Petitioner's Community One-Half Interest Thereof was Taxable to Him in said Years. (Assignment of Error I)

The sole question in this case is whether the following amounts received by the petitioner from the two Newells:

1940: $2,603.65 (Exclusive of $2,603.65 credited on their loans) (Stip. 23, R. 57, 37)

1941: $12,799.99 (Exclusive of $5,772.01 credited in payment of the balance of their loans) (Stip. 25, R. 58, 39)

in accordance with the provisions of Exhibits 8 (R. 104-107) and 9 (R. 108-111), the main consideration for which was:

> "IN CONSIDERATION that the second party [Yost] shall consent to and enter into a certain contract between the Pacific Car and Foundry Company, a corporation, Tricoach Corporation, a corporation, *et al.*, a copy of which is attached hereto and marked 'Exhibit A,' * * *" (Exhibits 8 and 9, R. 105, 108)

were capital gains as contended by the petitioner, or ordinary income as contended by respondent and held by the Tax Court (R. 45).

If they were capital gains, they were long-term capital gains under Section 117 I.R.C.*, and only 50% thereof are to be taken into account in computing taxable income for the respective years, while if ordinary income the full amount is subject to tax in said years.

Petitioner claims that said amounts were derived from the sale or exchange of capital assets. There can be no question but that the 510 shares of stock of Tricoach Corporation owned by petitioner were capital assets as defined by Section 117 I.R.C.

Just prior to the time the four-party agreement (Exhibit 7, R. 80-104) and the agreements with the two Newells (Exhibits 8 and 9, R. 104-107, 108-111) were entered into, petitioners 510 shares of stock of Tricoach Corporation had two elements of value:

(a) 51% of the net tangible assets, cash and accounts receivable of the corporation. On liquidation this proved to be the par value of said shares, or $25,500 (Stip. 24, R. 57), the par value of each share being $50. This is further borne out by the fact that in both 1936 and 1937, the corporation distributed as dividends the entire net income of each of said years (Exhibits 3 and 5, R. 69, 72), so that at the end of each of said years the corporation had no surplus or deficit (Stip. 10, 13, R. 51, 52).

(b) 51% of the intangible or going concern value

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*Note: Section 115 I.R.C.—"Distributions by Corporations" and Section 117 I.R.C.—"Capital Gains and Losses," so far as material to the question involved herein, are printed in the Appendix of this Brief.

of the corporation. Yost and the two Newells at the first conference with the officials of the Pacific Car & Foundry Co. considered all the stock of the corporation to be worth $100,000 (R. 130, 146), which indicated to their minds, at least, that the stock was worth double its par or book value, or that it had a value of $50,000 in excess of its net assets. Robert L. Newell testified (R. 141) that when they were clearing themselves with Yost, in arriving at the amounts to be paid Yost, the two Newells figured $50,000 for the physical value of the corporation and $50,000 for the value of the going business, and since Yost had 51% of the stock, $25,000 was his share of the value of such going business (R. 141).

Petitioner testified he would not have agreed to Tricoach Corporation going out of business except for the consideration to be paid him by the two Newells as set forth in Exhibits 8 and 9, and the Tax Court so found (R. 40-41). His testimony in this regard is:

> "Q. Now referring to Exhibits 7 and 8, with which I think you are thoroughly familiar—Exhibits 8 and 9, I mean, — will you state the reason, on the basis of that discussion, that additional consideration or compensation set forth in those agreements was to be paid for you?"
>
> "A. To put it simply, it was just compensation over and above my interest in the Tricoach Corporation to get me to step out of the business. It was just additional consideration, because the Company had been doing a very profitable business, and I would not step out for just my equity in the assets of the Tricoach Corporation." (R. 132)

* * * * * * * * * *

"Q. Were you prepared to step out of the Tricoach Corporation merely on the basis of getting your original capital back at that time?"

"A. I was not." (R. 133)

* * * * * * * * * *

"Q. I have just a couple of more questions. Exhibit 7, as I stated, is the four-party agreement. Would you have signed Exhibit 7 if it had not been for the additional consideration provided to be paid to you in Exhibits 8 and 9?"

"A. I certainly would not." (R. 133)

Would anyone in petitioner's position have agreed to Tricoach going out of business unless he was to be paid an additional consideration by the Newells?

Here was a corporation that commenced business in January, 1935, with an original capital of $8,000, of which petitioner supplied $7,500 and the Newells $250 each (Stip. 6, R. 48). By the end of 1937, the corporation had paid to petitioner in dividends and salary a total of $41,686.38, out of which he made payments back to the corporation of $1,001.42 in payment of his pro-rata of the 1935 deficit and $18,000 in payment for 360 additional shares, leaving him with a net amount of $22,684.96, and he owned 510 fully-paid up shares, or 51% of the stock of the corporation (Stip. 14, R. 53; Opinion R. 31).

Each of the Newells, on his $250 original investment, had fared equally well. The stipulated facts show they each received: in 1935, $2,750 salary (Stip. 8, R. 49); in 1936, $3,300 salary and $10,140.95 adjusted compensation (Stip. 10, R. 50) also $388.32 in dividends on their 5 shares of stock (Stip. 9, R. 49); and in 1937, $3,600 salary and $11,927.71 ad-

justed compensation (Stip. 13, R. 52) also $3,827.81 dividends on their 245 shares (Stip. 12, R. 52), or a total in the three years of $35,934.79 out of which each paid $33.38 on his pro-rata of the 1935 deficit (Stip. 10, R. 51) and invested $12,000 in payment of the 240 additional shares (Stip. 9, 11, R. 50, 51), leaving each with $23,901.41 net cash after such payments.

Here, then, we have a corporation that in three years paid to its three stockholders a total of $113,-555.96 in salaries and dividends. It would seem that said corporation had a going concern value of far more than the $50,000 they themselves put into it.

Is it any wonder that petitioner was not willing to have the corporation go out of business as contemplated by the four-party agreement (Exhibit 7), unless he was to be paid something over and above the liquidation value of his stock?

This the two Newells were willing to do, and the maximum each was to pay (Exhibits 8 and 9, R. 104, 108) was fixed at $12,500, *i.e.*, one-third of the first $37,500 each Newell was to receive out of his one-sixth share of the profits of the Motor Coach Division of the Pacific Car & Foundry Co. (Exhibit 7, R. 83).

Such payments were agreed to be made by the Newells for Yost's consent to the entering into by Yost and Tricoach Corporation of the four-party agreement (Exhibit 7), which necessarily resulted in Tricoach going out of business and liquidating its affairs.

The Tricoach Liquidatiton Dividend received by petitioner was in exchange for his stock.

There is no question but what Tricoach Corporation was completely liquidated. When asked on cross-examination as to the present status of Tricoach Corporation, Mr. Yost answered:

> "It is in existence in name only. There are no assets or liabilities, and there were a couple of reasons why we saw fit to continue to pay the state corporation license, which costs only $15 per year, in order to keep the Corporation alive in the event we would want to use it for some other purpose. I have done that for no other reason. It is cheaper than to create a new corporation if we merely keep it alive. It was entirely liquidated." (R. 134)

On June 26, 1940, petitioner received $25,500 from Tricoach Corporation on its liquidation (Stip. 24, R. 57; Opinion R. 38), said amount being the par value of petitioner's shares.

Section 115 I.R.C. (see Appendix) is entitled "Distributions by Corporations." Sub-section (c) thereof provides:

> "(c) Distributions in Liquidation. — Amounts distributed in complete liquidation of a corporation shall be *treated* as in full payment in exchange for the stock * * *." (Italics supplied)

The use of the word "treated" must have been for some good reason. It raises the question of: treated for what purpose? The only logical answer would be for "income tax purposes" since said section is a part of Chapter 1 of the Internal Revenue Code which deals entirely with income taxes.

The Tax Court stated (R. 41), in regard to said section:

> "It is doubtful if we are at liberty to construe it, as petitioner obviously wishes it to be construed, as meaning in part payment for the stock."

Petitioner made no such contention in the Tax Court, nor does he do so here. Petitioner does contend that since said Section 115 deals only with "Distributions by Corporations," the words "full payment" can refer only to payments made by the corporation in exchange for the stock.

Applying said provision to the liquidation distribution in this case, it means that the $25,500 distributed in complete liquidation of Tricoach Corporation shall be treated for income tax purposes as in full payment by Tricoach Corporation in exchange for petitioners stock in said corporation.

Said section accordingly specifically provides that such complete liquidation distribution is "in exchange for the stock."

Accordingly, such "exchange" brings the stock within the definition of the Capital Gain and Capital Loss provisions of Section 117 I.R.C.

The payments from the Newells resulted in gains to petitioner from the exchange of capital assets, and hence were capital gains.

As shown above, the $25,500 liquidation distribution by Tricoach in June, 1940, is treated as full payment by Tricoach in exchange for the stock, by Section 115(c) I.R.C. Said stock cost petitioner $26,-

501.42, so that on the liquidation of Tricoach, there was a capital loss of $1,001.42 (Stip. 24, R. 58). In 1940, the Newells paid petitioner $2,603.65 in addition to a like amount on advances (Stip. 23, R. 57). Such payment was not made by Tricoach Corporation so it is not governed in any way by Section 115(c) I.R.C., which applies only to distributions in liquidation. Since the liquidation distribution by Tricoach resulted in a capital loss, the three-year distribution plan provisions italicized in Section 115(c) I.R.C. as set forth in the Appendix, do not apply. Such three-year plan applies only to liquidation distributions by a corporation which results in a capital gain, not in a capital loss.

The additional consideration received by petitioner in 1940 and 1941 from the Newells did result in a capital gain on the entire transaction, but such payments did not constitute liquidation distributions from Tricoach Corporation. In other words, in 1940 the net results of the payments received by petitioner was as follows:

The $25,500 liquidation distribution from Tricoach Corporation resulted in a community long-term capital loss of	($1,001.42)
The $2,603.65 paid by the Newells resulted in a community long-term capital gain of	2,603.65
Net community long-term capital gain	1,602.23
50% thereof to be taken into account	$ 801.12
½ thereof to be reported by petitioner on his separate return	$ 400.56

That this is exactly the same result as is contended for by petitioner is shown by the following:

Deductible loss on liquidation of Tricoach allowed petitioner by respondent (Stip. 24, R. 58)	($250.35)
Capital gain taken into account by petitioner for tax purposes, on his one-half of the payments made by the Newells (Stip. 27, R. 59)	650.91
Net capital gain	$400.56

It is petitioner's contention that this case is governed by the case of *David A. DeLong v. Commissioner*, 43 B.T.A. 1185. In that case it appeared that DeLong was a minority stockholder of American Broach & Machine Co. The remaining shares were owned by one Lapointe, individually or trustee, and his wife. Lapointe was also its president and general manager. In 1936, Lapointe negotiated with DeLong to have him exchange his stock in the American Company for 782 shares in the Sundstrand Machine Tool Co. in a proposed reorganization which Lapointe was negotiating. At one stage Lapointe offered to buy DeLong's stock for $10,000.00 as he had to have DeLong's stock to complete the deal and was willing to pay him for it. DeLong decided he wanted $30,000.00 in Sundstrand stock or its cash equivalent for his American stock, which Lapointe refused. They finally agreed that DeLong should receive 782 shares of Sundstrand stock or its equivalent in cash, at $10.00 per share, and $14,000.00 in cash to be paid by Lapointe. DeLong was not willing otherwise to go along with the reorganization. The reorganization was effected and DeLong received 782 shares of Sund-

strand stock, which was issued direct to him by the Sundstrand Company, and he received $14,000.00 in cash from Lapointe.

The Commissioner, in auditing DeLong's return, held that the $14,000.00 cash paid by Lapointe was not a part of the agreement of reorganization and that such payment constituted ordinary income taxable in full. DeLong claimed that the $14,000.00 constituted part of the sales price of the capital asset and was therefore a capital gain. The Board of Tax Appeals held in favor of DeLong, stating at page 1187:

> "Even though we assume, asurged by respondent, that petitioner participated in the plan of reorganization, and obtained from that source the Sundstrand stock in exchange for his American Co. shares, *it does not follow that the additional consideration he received for selling his stock was ordinary income as opposed to capital gain. There is no requirement of which we have been made aware that the sales price of an article cannot be paid in whole or in part by one other than the vendee.* It seems to us to be apparent from the record that petitioner disposed of his American Co. stock and received in exchange 782 shares of Sundstrand stock and $14,000 in cash. 'That was the crux of the business' to petitioner, as it should be to us. *Griffiths v. Helvering*, 308 U.S. 355, 357. We see no reason why the total consideration should not be treated as the sales price of the stock, and the excess over cost as capital gain. *James Brown*, 10 B.T.A. 1036, 1054." (Italics supplied)

The respondent has acquiesced in such portion of

the decision as is apparent from the following 1941-1 Cum. Bull. 3:

> "Acquiescence relates only to the issue, Is the $14,000 cash received by the petitioner on February 6, 1936, from Francis K. Lapointe a part of the consideration of the petitioner's American Broach & Machine Co. stock?"

That the *DeLong* case is similar to the instant case is shown by the following:

In both cases there was an exchange of stock, in the cited case for other stock, while in the instant case for the liquidation distribution; in both cases cash was paid, in the cited case by Lapointe, the main stockholder in American, while in the instant case by the Newells, the only other Tricoach stockholders; in both cases the additional remuneration was necessary to transfer a going business to a third party, Sundstrand in the cited case and Pacific Car & Foundry Co. in the instant case.

While it is true that in the cited case the exchange and cash paymments were made at one time, while in the instant case the liquidating dividend and the payments by the Newells necessarily were not to be made until sometime in the future, nevertheless such future payments would not alter the principle, namely, that they were payments in exchange for a capital asset, and therefore capital gains when received.

In the recent case of *Margery K. Megargel v. Commmissioner*, 3 T.C. 238, where petitioner had transferred stock but later instituted action to annul the transaction and for the recovery of the stock and the action was compromised and settled, the petitioner re-

ceiving cash upon an agreement to dismiss and execute general releases, including the claim in suit, petitioner having no other claim against the defendants, the Tax Court held that the amount was received upon the sale of capital assets and was therefore a capital gain, stating:

> "It is now well settled that recognition of capital gain or loss does not depend upon the existence of usual or sterotyped forms of conveyance. It may rest upon involuntary sales through mortgage foreclosure. *Helvering v. Hamel*, 311 U.S. 504, *Electro-Chemical Engineering Co. v. Commissioner*, 311 U.S. 513; or upon loss of property through condemnation proceedings by the state or municipality. *Hawaiian Gas Products, Ltd. v. Commissioner*, 126 F.(2d) 4; *Commissioner v. Kieselbach*, 127 F.(2d) 359. In *Estate of James N. Collins*, 46 B.T.A. 765 (768) involving purchase of stock under fraudulent representations, later sale thereof and deduction of loss, and the compromise of suit filed thereon at a later date, we said:
>
> "'* * * True, the decedent had already sold the stock in 1930 and 1931, but that fact does not require the conclusion that the transactions were completely closed at that time, because the decedent still maintained his right of action against the company'."

It is admitted that the arrangements between Yost and the Newells were not the "usual or sterotyped form of conveyances" but they did provide a method whereby Yost was to receive for his Tricoach stock what he believed to be its approximate going-concern value.

That the arrangement was a friendly one is evidenced by the following testimony of Mr. Robert L. Newell on direct examination:

> "A Well, Mr. Yost agreed with that amount that we fixed as the value of the business, and we entered into an agreement to pay him that. That is all there is to it.
>
> "Q Did Mr. Yost make any statement in your presence as to whether or not he would sign the agreement with the Pacific Car and Foundry Company unless he got additional consideration?
>
> "A Mr. Yost did not, because he never had to; he knew we would never make an agreement with the Pacific Car & Foundry Company without his consent." (R. 42)

And on Mr. Newell's cross-examination, in answer to the question as to what he meant by his testimony on direct that "before entering into any contract with Pacific Car & Foundry Company it was necessary to clear yourself with Mr. Yost," he said:

> "A I mean that they—rather that we would have to get his agreement that we could do that; we had entered business with Mr. Yost, and we were going to stay there until the agreement was made, or until he agreed that we could accept some other proposal". (Tr. 28) (R. 143, 144)

The stipulated facts and exhibits and the testimony clearly show that Yost was willing to step aside so that the Newells could enter the Pacific Car and Foundry Co. organization, provided some agreement could be reached whereby Yost should ultimately receive what he believed to be the fair value of his Tricoach stock. He was willing to accept the proposals set forth in

Exhibits 8 and 9 to accomplish that, and " 'That was the crux of the business' to petitioner as it should be to us," *David A. DeLong v. Commissioner*, 43 B.T.A. 1185, or, to again quote Mr. Newell, "That is all there is to it" (Tr. 26) (R. 142).

Petitioners claim that the arrangements made are no different in practical effect than if petitioners had sold their stock to Pacific Car & Foundry Co. for its par value payable when Tricoach was liquidated, and as an inducement for such sale the Newells agreed to make the payments set forth in Exhibits 8 and 9.

Agreements between Yost and Newells, Exhibits 8 and 9, did not constitute a joint venture.

Before the Tax Court, respondent argued that the arrangememnt between petitioner and the Newells evidenced by Exhibits 8 and 9 constituted a joint venture and hence the profits thereof were ordinary income, taxable as such.

The Tax Court evidently was impressed with such argumment because it stated:

> "* * * and in consideration of petitioner advancing to each of the Newells $4,187.83, they agreed to share the profits which should be received from the Motor Coach Division of Pacific. The amounts in issue represented his share in the profits.
>
> "In our opinion respondent is correct in designating the payment made by the Newells, to petitioner as the fruits of a joint venture. * * *" R. 44, 45)

That such statement of the Tax Court is clearly erroneous, can easily be demonstrated.

In the first place, Exhibits 8 and 9 provide that each Newell agreed to pay to petitioner an amount equivalent to:

> "One-third of all *compensation*, or damages in lieu thereof, not in excess of Thirty-seven Thousand Five Hundred Dollars ($37,500.00), said first party shall receive or be entitled to receive from the Pacific Car and Foundry Company by reason of said contract as set forth in Exhibit 'A' attached, exclusive of the minimum salary of $250.00 per month *and rental income* separately set forth in said contract.
>
> "Payments to be made within three (3) days after first party shall receive an accounting and settlement of *his adjusted bonus compensation* from the Pacific Car and Foundry Company for each respective calendar year or fractional period." (R. 105, 108) (Italics supplied)

Also, Exhibit 7 provides:

> "In addition to said minimum salary above mentioned, first party [Pacific] will pay to each of the second parties [Newells] one-sixth (1/6) of the 'profits' of the business of said Motor Coach Division earned during said term of years. * * *" (R. 83, 84)

Such provisions make it clear that the share of the "profits" was considered by all parties to be compensation for the services of the Newells to the Motor Coach Division of Pacific, and the Newells were not parties to a joint venture with Pacific. They were simply department managers of Pacific with their compensation, above $250 per month, contingent upon the success of the business. If the present Withholding Tax had been in effect in those years it is incon-

ceivable that the respondent would rule that such "adjusted bonus compensation" when payable to the Newells was not subject to the Withholding Tax because it was their share in the profits of a joint venture.

Secondly, if there were a joint venture between petitioner and the Newells, why were separate agreements entered into with each Newell (Exhibits 8 and 9)?

Thirdly, if the advances to the Newells to enable them to purchase the machinery from Tricoach, was a capital investment on petitioner's part in a joint venture, is it consistent with such idea that the *rental income* from such machinery was to be excluded from the share of the amount of compensation to be paid by the Newells to petitioner?

In the fourth place, said Exhibits 8 and 9, considered with the testimony of Yost (R. 132, 133, 138) and Robert L. Newell (R. 141-144), as to the reason of making the payments to petitioner, certainly negatives any idea of a joint venture.

The situation was simply that the Newells recognized that petitioner was entitled to receive from them $25,000 as his share of the value of the going business of Tricoach that he would lose if Tricoach went out of business. That they did not have the money to pay him outright, is easily surmisable when it is considered that they had to borrow the money from petitioner to buy the machinery from Tricoach. Exhibits 8 and 9 clearly indicate that the only way they could pay petitioner was out of any "adjusted bonus

compensation" they might receive from Pacific, and that is what actually happened, but the fact that they did carry out their agreements with petitioner did not make such arrangement a joint venture.

In *James Brown, et al. v. Commissioner*, 10 B.T.A. 1036, 1045, 1054, it was held that payments made by one Bache of 15% of back salary payments when received by him, which he had agreed to pay to Brown as an inducement to Brown to purchase certain stock in a corporation in which Bache was the majority stockholder, did not constitute taxable income to Brown, but amounted to a reduction in the cost of the stock to Brown. The arrangement in that case was no more a joint venture than is that of the instant case.

A consideration of the whole picture can lead to no other conclusion than that the payments received by petitioner from the Newells were received in connection with his consent to accept from Tricoach Corporation the liquidation value of his stock. and thus were capital gains.

II.

The Correct Deficiency in Petitioner's Income Tax for 1940 is $2.57 and There is No Deficiency for 1941. (Assignment of Error II).

If petitioner's contentions that the payments received by him from the Newells are capital gains and not ordinary income, then it was stipulated that the correct deficiency for 1940 is $2.57 (Stip. 29, R. 59; Opinion R. 39) and that there is no deficiency for the year 1941 (Stip. 32, R. 60; Opinion R. 40).

CONCLUSION

It is respectfully submitted that the Tax Court erred in holding that the payments received by petitioners from the Newells constituted ordinary income; that they should be held to be capital gains by this Court and the decision of the Tax Court reversed with instructions to enter the correct deficiency in accordance with the stipulation.

Respectfully submitted,

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APPENDIX

Sections 115 and 117, Internal Revenue Code

"SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

"(c) Distributions in Liquidation.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. *Despite the provisions of section 117, the gain so recognized shall be considered a short-term capital gain, except in the case of amounts distributed in complete liquidation. For the purpose of the preceding sentence, 'complete liquidation' includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding, from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years, if the first of such series of distributions is made in a taxable year beginning after December 31, 1937, or (2) two years, if the first of such series of distributions was made in a taxable year beginning before January 1, 1938.* * *"

(Note: The above provision was in effect during 1940 and 1941, but the italicized portion was eliminated by the 1942 Revenue Act amendment of said section, which amendment was not retroactive.)

"SEC. 117. CAPITAL GAINS AND LOSSES.

"(a) Definitions.—As used in this chapter—

"(1) Capital Assets.—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1);

"(2) Short Term Capital Gain.—The term 'short-term capital gain' means gain from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * * * * *

"(4) Long-Term Capital Gain.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

"(5) Long-Term Capital Loss.—The term 'long-term capital loss' means loss from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such loss is taken into account in computing net income;

* * * * * * * *

"(b) Percentage Taken Into Account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

'100 per centum if the capital asset has been held for not more than 18 months;

66 2/3 per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

"50 per centum if the capital asset has been held for more than 24 months."

* * * * * * * *